Wealth Planning Strategies for Dentists

Professional Corporations: Tax advantages and more...

Dentists, like many other professions can benefit from having a professional corporation as part of their overall wealth planning strategy.

What is a Professional Corporation? Sole Proprietor vs. Incorporation

The most basic way of setting up your business is as a sole proprietor. You operate under your own name; it is relatively inexpensive with few legal formalities. As a dentist your are allowed to practise your profession through a professional corporation. By incorporating, you create a legal entity that is separate from you. While this is more complicated, it does come with advantages.

Benefits

The main reason to consider a professional corporation is the potential tax advantages. However, some additional benefits can be considered as well.

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Tax Deferral

The key tax benefit of a professional corporation is the ability to defer income taxes, allowing you to increase your amount of savings. This benefit arises from the low tax rates corporations pay on active business income. The first $500,000 is taxed at 12.2% in Ontario, the small business rate, which is considerably lower than the top personal tax rate in Ontario of 53.53%.[1]

When you practise as a sole proprietor, all your income is taxed personally at the applicable graduated rates, eventually reaching 53.53% in Ontario. When you practise through a corporation, you are subject to two levels of tax, once at the corporate level and then again at the personal level.[2] The taxes you pay personally will depend on if you receive that money from your corporation as a salary or as dividends. If you can leave after-tax profits in the corporation, this can result in a tax deferral of up to 41.33% in Ontario. A simplified illustration shows how this can impact you:

SOLE PROPRIETOR		PROFESSIONAL CORPORATION		
			All income taken out personally	Income retained in corporation
Practice Income	$ 250,000	Practice Income Earned in Corporation	$ 250,000	$ 250,000
		Salary Draw	$ 250,000	$ 150,000
		Corporate Income	$ -	$ 100,000
		Small Business Tax Rate	12.2 %	12.2 %
		Afte-tax Profits Retained in Corporation	$ -	$ 87,800
Personal Taxable Income	$ 250,000	Personal Taxable Income	$ 250,000	$ 150,000
Top Personal Tax Rate	53.53 %	Top Personal Tax Rate	53.53 %	53.53 %
After-tax Personal Income	$ 116,175	After-tax Personal Income	$ 116,175	$ 69,705
		Total Corporate & Personal Income	$ 116,175	$ 157,505
		Total Tax Deferral	$ -	$ 41,330

Tax Deferral Impact – Sole Proprietor vs. Incorporation

You can invest the after-tax profits and the deferred taxes inside the professional corporation. Over time this should result in a higher account value than if you had been saving personally through a sole proprietorship. Any income produced from these investments in the corporation is considered passive investment income. Once your corporation earns passive income that exceeds $50,000 in a year, the amount of corporate profits taxed at the low 12.2% rate is reduced.[3]

Income Splitting

Before the regulation changed in 2018 and the introduction of the TOSI rules, there were more opportunities for tax savings through the ability to split income across family members.[4] And this involved adding certain family members as shareholders and paying them dividend income. The ability to split income through dividends is now quite limited and subject to some very specific and narrow exceptions, so you shouldn't expect to find much in the way of benefits here. Although of note, once you turn 65, you will be able to pay dividends to your spouse without the TOSI rules applying. And this can be an important aspect of generating cash flow in retirement (you should consult your profession's governing body for any shareholder restrictions). There is still the potential to pay wages to family members, but this is subject to the actual work they perform for the business. And the amount of the salary should be reasonable for the work provided. You also do not need to be incorporated to pay a family member a salary, and this kind of income splitting can be achieved with a sole proprietorship.

Capital Gains Exemption

You may be able to sell the shares of your professional corporation in the future. If they are considered qualified shares of a small business corporation, they could be eligible for the lifetime capital gains exemption. This could allow up to $1,016,836 of capital gains to be received tax-free.[5] You might not qualify for the exemption if your corporation has significant non-business assets, such as an investment portfolio. As well, you will need to find a buyer for your shares.

Other Advantages

You will have flexibility in paying yourself a salary versus dividends; as the tax rules are adjusted, there can be times when one form is more favourable to the other. Although currently, there is little difference between the two from a tax perspective. Paying life insurance premiums out of your corporation can be beneficial; they won't be tax-deductible, but this is another way to benefit from the lower corporate tax rate. Your corporation can also be an effective way to make charitable donations. There is some asset protection from business creditors, but a professional corporation does not protect against a malpractice or negligence lawsuit.

Disadvantages

Operating your practice through a professional corporation comes with increased complexities and costs. Maintaining a corporation requires greater regulation and compliance, such as maintaining additional records and passing resolutions to pay dividends. There will be higher legal and accounting costs, with fees to set up the corporation and ongoing expenses for tax returns, financial statements, and a corporate minute book. There is a restriction on using corporate money for personal needs; the after-tax profits belong to the corporation and can't be used for personal expenses unless you withdraw the funds first and pay any associated taxes. The professional corporation will also need to be integrated into your estate planning to avoid any double taxation.[6]

Setting up a professional corporation is not a one-size-fits-all decision. One of the primary benefits is holding and investing the surplus, after-tax profits in the corporation over the long term. We can help you work through the advantages, savings, and costs of incorporating so that you make the decision that is right for you.

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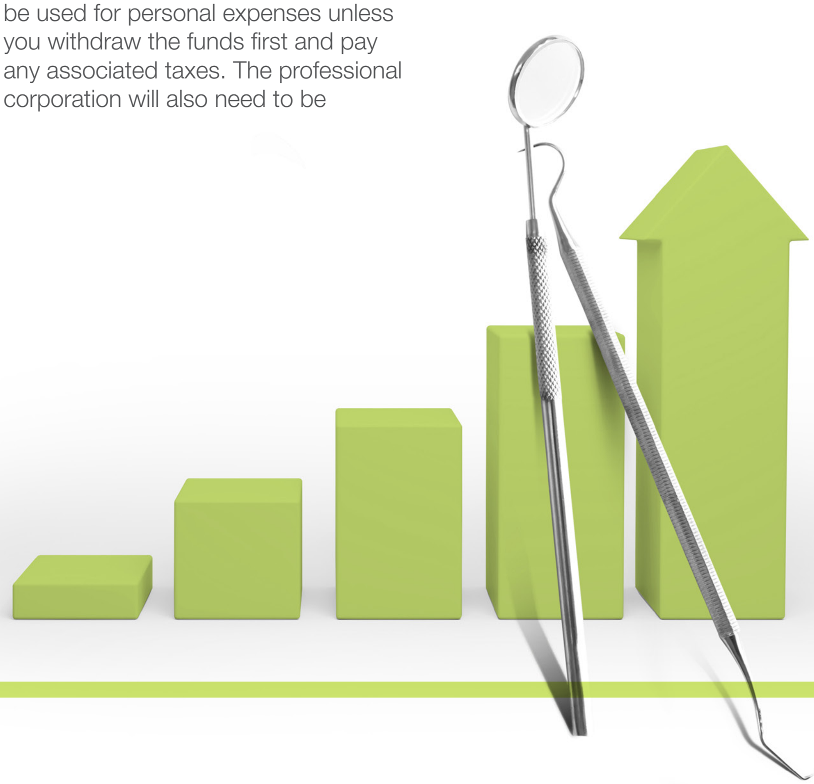

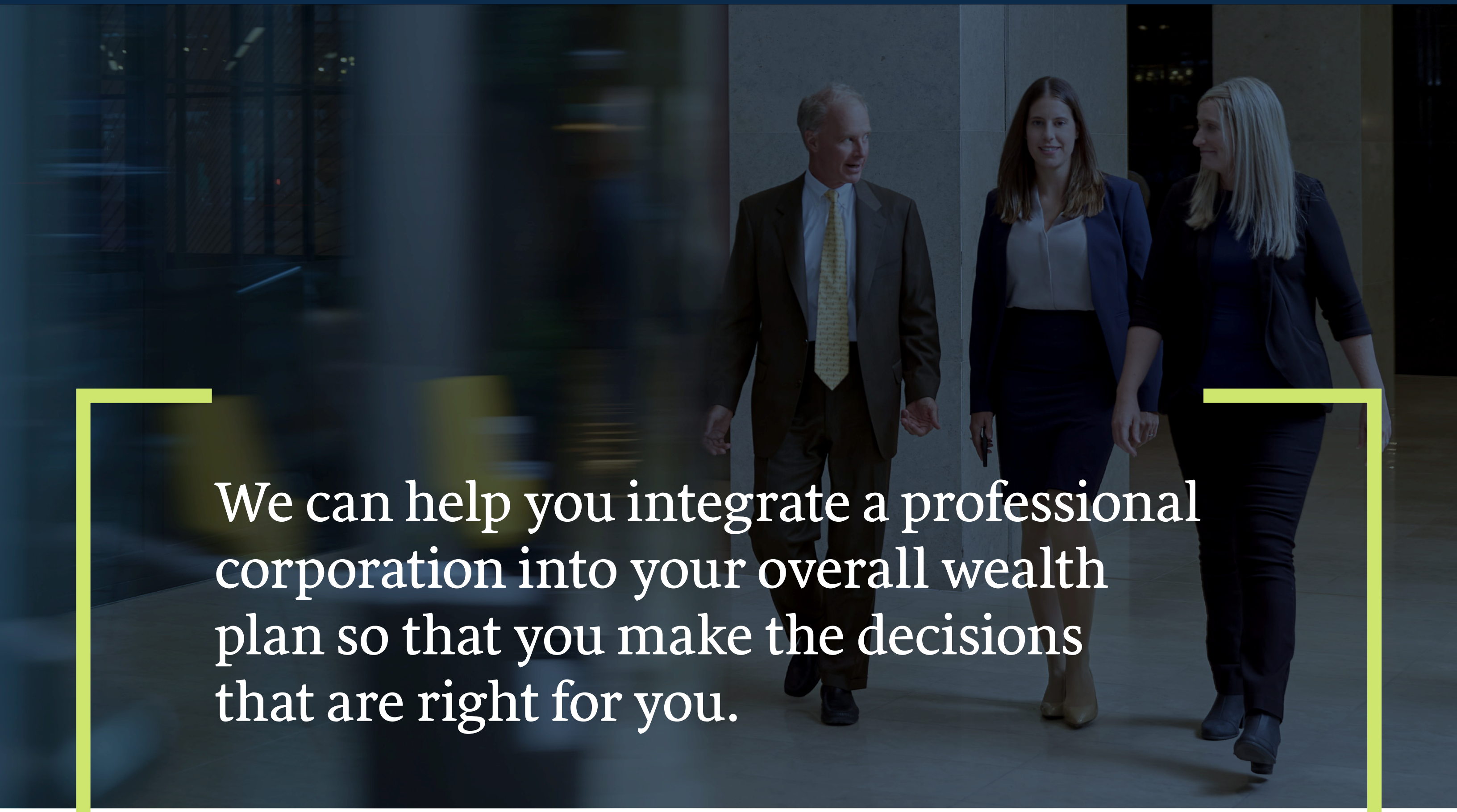

Put our wealth planning and investment management expertise to work for you. Contact your Nexus client service team.

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Notes:

1) The first $500,000 is typically subject to the Small Business Deduction. The rate varies by province from 9% to 12.2%. If the income does not qualify for the Small Business Deduction or is in excess of the threshold, the general corporate rate applies, which is 26.5% in Ontario and ranges from 23% to 31% across the provinces. All rates as of 2024.
2) The tax rules around corporations are designed so that ultimately once you receive the money personally, you will have paid the same tax rate as if you earned the money as a sole proprietor. This concept is called Integration, although in practice, there are usually small differences in the actual tax rates paid.
3) For every $1 of passive investment income above $50,000, the $500,000 Small Business Deduction is reduced by $5. Once passive investment income reaches $150,000, the Small Business Deduction is eliminated.
4) TOSI stands for Tax on Split Income and is a set of rules introduced that effectively applies the highest marginal tax rate to most dividend payments made to family members eliminating the previous tax advantages of doing so.
5) Based on the 2024 Capital Gains Exemption amount, which is indexed to increase each year.
6) The tax treatment of the shares you own in your professional corporation can potentially give rise to double taxation, but properly structuring your Will and estate plan can eliminate this risk.

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